Will inflation take off? How can this risk be managed?

These are currently key questions for investors. Recent UK annual inflation prints have been high. August saw CPI at 3.2% and RPI at 4.8% - the highest they've been in almost a decade. While there has been some respite in September inflation is expected to remain elevated over the next year. Investors are therefore rightly considering inflation risks and how to manage them, but are there enough inflation linked assets?

There is plenty of debate as to whether the recent high inflation prints augur a prolonged period of high inflation. Our observation is simply that inflation risk seems elevated; there is no denying that a high inflation scenario looks more plausible now than at any time in recent memory. Investors are therefore rightly considering inflation risks and how to manage them.

The situation is particularly acute for investors such as pension funds with contractual liabilities linked to inflation and assets without a matching exposure. This is because a higher-than-anticipated inflation environment may not only negatively impact assets but also increase liabilities more than previously expected. Such a 'double whammy' could significantly impact balance sheets.

Indeed, a recent survey commissioned by Alpha Real Capital revealed that a significant proportion of pension fund investors (over 70%) see a moderate or high risk that higher levels of inflation may persist in the longer term. Over half of the respondents also said they planned to increase their level of inflation hedging.

To add to heightened inflation fears, schemes are moving closer to their endgame faster than expected. Funding levels have fared well, and in many cases, actually improved through the pandemic as a result of the strong performance of risk assets. This means that pension funds are not only wanting to de-risk but many more can actually afford to do so. While this is of course a good thing, it does mean demand for inflation linked assets remains high. The recent announcement that the RPI measure will be reformed to be in line with CPIH, albeit not great news for holders of inflation-linked gilts, provides more certainty and has also catalysed some pent-up demand for inflation linked assets. All of this leads to the question of whether there is enough supply to meet demand?

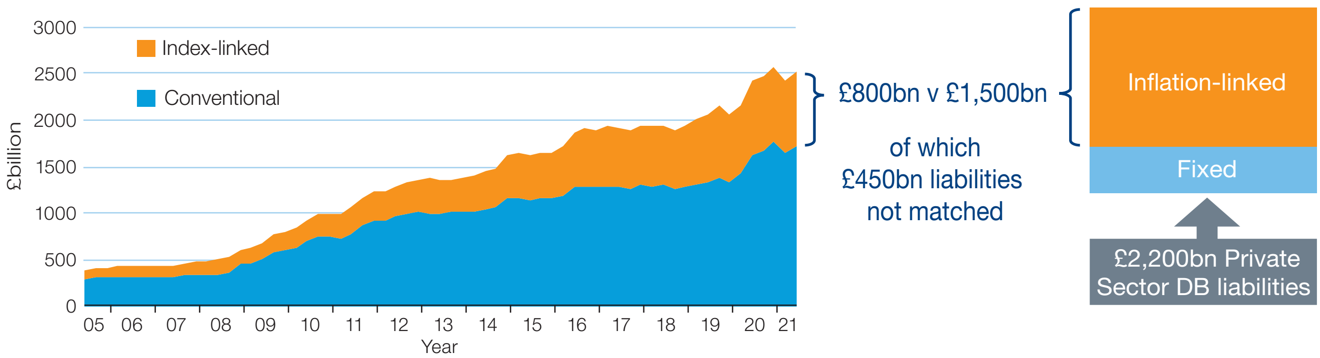
Demand exceeds supply

To get an idea of the (im)balance of supply and demand, let's look at the dominant sources of both.

UK private sector defined benefit ('DB') schemes are currently the largest source of demand (see box on next page for other sources). On the supply side we focus on the index-linked gilts market, as this is the go-to asset for pension funds wanting to hedge inflation – also it is by far the largest supply of long-dated inflation linked assets in the UK and underpins much of the RPI swaps market. In contrast, there is little supply of corporate index-linked paper.

The chart below compares these sources of supply and demand. Despite the stock of index-linked gilts (and nominal gilts!) increasing substantially since 2005, there is still not enough to meet demand.

Market value of gilts and index-linked gilts



Source: Office for National Statistics, Pension Protection Fund, Alpha Real Capital calculations

Rounding for simplicity, total UK DB pension fund liabilities come in at around £2,200bn*, of which c.£1,500bn are inflation linked. Given there are only £800bn of index-linked gilts, straightforward arithmetic indicates there is a shortfall of £700bn. However as many schemes use LDI techniques, the portion of inflation-linked liabilities that are matched is actually higher at around 70% – or £1,050bn. That still leaves 30% or c.£450bn of un-hedged inflation linked liabilities.

* For those interested – we have estimated the pension fund liabilities as the value of full buy-out liabilities using Pension Protection Fund figures (Purple Book 2020 and August PPF 7800 Index). We have assumed 2/3rds of liabilities are inflation-linked.

Other sources of demand for inflation-linked assets:

- **Local Government Pension Schemes represent another c.£300bn of liabilities. Although the nature of the demand has been different to private sector schemes, government spending cuts and a spate of privatisations (e.g. in the transport sector) mean schemes are requiring to match liabilities more keenly.**
- **Insurance annuity portfolios, currently another c.£350bn. The liabilities are typically fully hedged, therefore as liabilities transfer from private sector DB schemes to insurers this is another source of demand for inflation linked assets.**
- **As population ages, retirees in search of inflation linked income will look to switch their retirement pots into inflation-linked assets.**

Is it the right kind of supply?

Looking at the supply side, it is worth looking beyond the headline numbers.

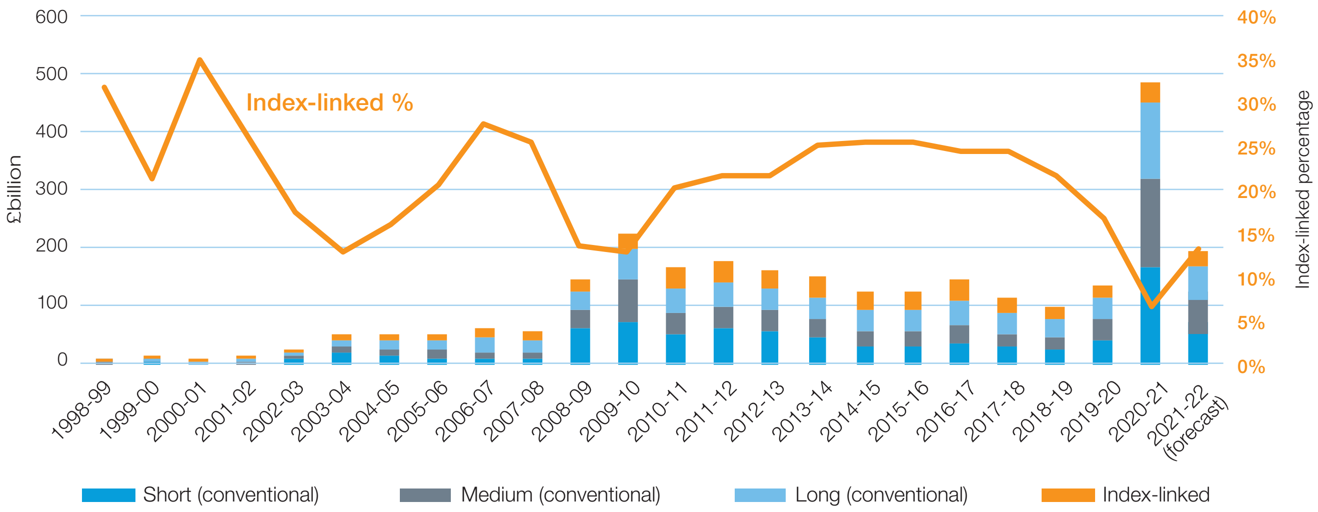
Firstly, despite the high level of gilt issuance practically every year since the financial crisis – with a truly record breaking £486bn raised in 2020/21 as the government needed to finance the fight against the pandemic - there remains a shortfall of index-linked gilts.

As an aside, much of the supply of nominal gilts has been absorbed by the Bank of England Quantitative Easing program, which holds c.£875bn of the gilts in issuance. It is worth mentioning in the context of our discussion that index-linked gilts are not included in the programme.

Secondly, as the chart below illustrates, while the absolute levels of index-linked gilts issuance has been high at an average of c.£30bn a year since the financial crisis, the proportion of total issuance that is index-linked has fallen dramatically from a high of 25% to as low as 5% more recently. So, while the governments financing needs are expected to remain substantial in the medium term, the supply of index-linked gilts is unlikely to satisfy demand.

The Autumn 2021 Budget led to a reduction in the government's borrowing requirements and a £50bn reduction in the amount of gilts that will be issued – this reduces gilt issuance significantly for the rest of this fiscal year. The announcement led to an immediate and substantial increase in gilt prices, highlighting the expected scarcity of supply.

Gilts and index-linked gilts - issuance



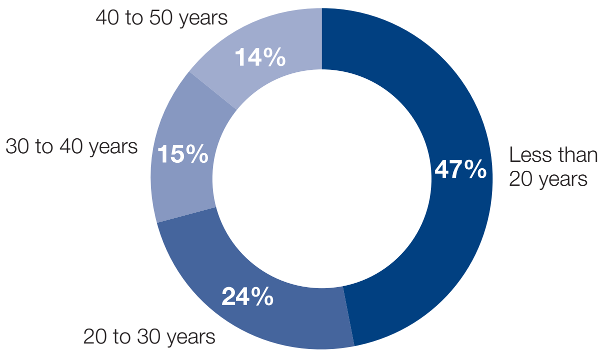
Source: Office for National Statistics, Debt Management Office

> So, while the governments financing needs are expected to remain elevated, the supply of index-linked gilts is unlikely to satisfy demand.

The third point to make is that pension schemes want to match long dated liabilities. This means they need long dated index-linked gilts. However if one looks at the composition of the current supply (see below pie-chart), out of 31 index-linked gilts only 14 have a maturity of more than 20 years and only 3 of these have a maturity greater than 40 years, representing only c.14% of the total market value of index-linked gilts.

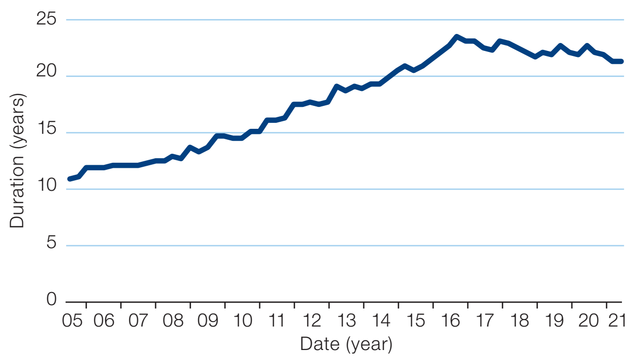
In fact the longest dated gilt (maturing in 2068) was introduced in 2013. With no extensions in maturity for nearly a decade and relatively low issuance at the long end, the duration of the index-linked gilt portfolio has fallen – as shown in the chart below.

Composition of index-linked Gilts market by maturity value



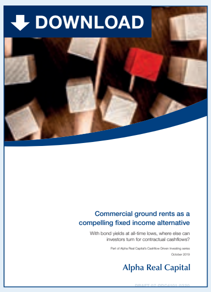
Source: Office for National Statistics, Debt Management Office

Average duration of the index-linked gilt market



Are there other sources of inflation linked assets?

In summary, there are not enough index-linked gilts, they are mostly not long-dated enough and future supply is not expected to be great. Demand on the other hand is expected to grow. Unfortunately, there are not many other sources of supply for long-dated inflation linked assets. Given this imbalance, Commercial Ground Rents (CGRs) may be the low risk, higher yielding alternative that investors are looking for. Compared to index-linked gilts, CGRs provide a better cashflow profile, an attractive risk-adjusted spread as well as offering inflation protection. All of these features, coupled with the supply shortage of index-linked gilts means a growing number of investors (including insurers) are investing in CGR.



In a recent piece, we took a closer look at some of the reasons why investors should consider CGR as an alternative inflation-linked asset and the relative benefits of holding these versus index-linked gilts.

An overview is below:

- The fastest growing segment of the long-lease property market, offering long-term annual inflation hedging characteristics through leases that can be structured to provide investors with contractual rental growth in excess of RPI.
- Provides returns that are expected to be 4% p.a. to 5% p.a. above index-linked gilt yields. This excess return is expected to compress as more investors invest in CGR which would also increase liquidity in the market.
- A better cashflow profile than index-linked gilts; the initial rents of around 2% on CGR mean the cash generated can be multiple times higher than the same investment in index-linked gilts.
- CGR spreads are not only attractive but the income stream is very secure by design. They can be thought of as long-term super senior lending collateralised by real estate assets. A key feature that enhances security is over collateralisation.

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